ANALYSIS OF ORIGINAL BILL

Franchise Tax Board

Author:	Hollingsworth	Analyst:	Jennifer Bettencourt	Bill Number:	SB 57
Related Bills:	See Legislative History	Telephone:	845-5163	Introduced Date:	January 11, 2007
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: PIT Rates/Reduce Marginal Rates & Eliminate Mental Health Services Surcharge Enacted By Proposition 63 On Or After January 1, 2011

SUMMARY

This bill would do the following:

- Reduce existing personal income tax (PIT) rates over a five year period to zero,
- Repeal the alternative minimum tax (AMT) at the end of that five year period,
- Repeal the 1% mental health tax imposed on taxpayers with taxable income in excess of $1 million dollars, and
- Change the method for taxing non-residents and part-year residents.

PURPOSE OF THE BILL

According to the author's office, the purpose of this bill is to eliminate the California personal income tax and alleviate the burden on individuals.

EFFECTIVE/OPERATIVE DATE

This bill, with the exception of the repeal of the 1% mental health tax, would be effective January 1, 2008, and be operative for taxable years beginning on or after January 1, 2007. The repeal of the 1% tax would be effective upon voter approval and eliminated as of January 1, 2011.

POSITION

Pending.

ANALYSIS

FEDERAL/STATE LAW

Federal law imposes five different income tax rates on individuals ranging from 10% to 35%. Existing state law imposes six different PIT rates ranging from 1% to 9.3%. Each tax rate applies to a different range of taxable income known as a "tax bracket." Existing state law requires the Franchise Tax Board (FTB) to recalculate the tax brackets each year based on the change in the California Consumer Price Index.

Board Position:			Department Director	Date
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A taxpayer with substantial income can use preferential tax benefits, such as exclusions, deductions, and credits, to reduce their income tax liability. AMT was established to ensure that a taxpayer who can use preferential tax benefits does not completely escape taxation. Federal law generally provides personal income AMT rates of 26% and 28%. Existing state law provides a personal income AMT rate of 7%. The federal AMT lacks a provision for automatic adjustments based on inflation, which is resulting in application of AMT to more taxpayers. The California AMT has an automatic adjustment, which assures that the state AMT applies to upper income taxpayers.

Starting with the 2005 taxable year, current state law imposes an additional 1% mental health tax, not subject to reduction by credits, on the portion of a taxpayer's taxable income that exceeds $1 million. The (estimated) revenue from the additional 1% mental health tax is deposited into the Mental Health Services Fund on a monthly basis, subject to an annual adjustment.

Non-residents are taxed on income sourced within California, while part-year residents are taxed on all income from all sources while a resident of California. Beginning with the 2002 taxable year, state law set rules for calculating loss carryovers, deferred deductions, and deferred income and implemented a tax computation method to recognize those items. Tax is computed by multiplying the California taxable income by an effective tax rate.

<u>THIS BILL</u>

Beginning with taxable year 2007, this bill would incrementally reduce the existing PIT rates to zero by the year 2011.

The tax rates proposed by this bill are as follows:

<u>Proposed PIT Rates</u>					
Current	*2007*	*2008*	*2009*	*2010*	*2011*
1%	0.80%	0.60%	0.40%	0.20%	0%
2%	1.6%	1.2%	0.80%	0.40%	0%
4%	3.2%	2.4%	1.6%	0.80%	0%
6%	4.8%	3.6%	2.4%	1.2%	0%
8%	6.4%	4.8%	3.2%	1.6%	0%
9.3%	7.54%	5.58%	3.72%	1.86%	0%

In addition, this bill would:

- Provide contingent enactment language that would eliminate the 1% mental health tax, subject to a ballot initiative and voter approval,
- As of January 1, 2011, repeal the California AMT, and
- Change the method for taxing non-residents and part-year residents.

This bill would calculate the tax for non-residents and part-year residents on income with a source in California at the same tax rates that would apply to a resident of California. The tax would be computed upon total income as if that individual were a resident for the entire year, and would be prorated based upon the ratio of adjusted gross income (AGI) with a source in California over AGI from all sources.

IMPLEMENTATION CONSIDERATION

The department has identified the following implementation concern. Department staff is available to work with the author's office to resolve this concern and other concerns that may be identified.

The bill specifies that the five-year phase-out begins with taxable years beginning January 1, 2007. Because the bill is not a tax levy, these sections of the bill would not go into effect until January 1, 2008.

It could be argued that this bill would provide a retroactive reduction in tax rates for taxable year 2007 that constitutes a gift of public funds. Department staff is available to assist the author in drafting an appropriate public purpose statement to resolve this issue.

The bill eliminates the defined term "taxable income of a nonresident or part-year resident" but does not modify or otherwise alter other provisions of law related to source rules where that the term is used. [RTC §17301, 17302, 17306, 17307, and 17062.] This could cause confusion and errors in computing tax and credits for nonresidents and part-year residents.

LEGISLATIVE HISTORY

Proposition 63 (Steinberg), approved by voters in the November, 2004, General Election, imposes a 1% tax on taxable incomes in excess of $1 million to provide a dedicated funding source for the expansion of mental health treatment options for children, adults, and seniors.

AB 1740 (AR & T Committee, Ch. 13, Stats 2004) among other things, clarifies the method of calculating the taxable income of nonresidents and part-year residents to eliminate concerns that were identified during the implementation of AB 1115 (Stats. 2001, Ch. 920).

AB 1115 (AR&T Committee, Ch. 920, Stats 2001) made major changes to the manner that nonresidents and part-year residents compute their tax for taxable years beginning on or after January 1, 2002, to ensure that California does not tax nonresidents and part-year residents (for the period of nonresidency) on income from sources outside this state.

AB 17 (Hollingsworth, 2001), a similar bill, would have incrementally reduced the personal income tax rate to zero by 2005 and eliminated the alternative minimum tax beginning in 2005. AB 17 failed passage in the Senate Revenue and Taxation Committee.

AB 643 (Baldwin, 1997) would have provided a 10% reduction in PIT rates phased in over two years; this bill remained in the Assembly Revenue and Taxation Committee.

SB 1326 (Alfred E. Alquist, Chap 372, Stats1982) changed the method of taxation of nonresidents or part-year residents so that the tax upon income having a source in California would be taxed at the same tax rates that would apply to a resident with the same total income.

OTHER STATES' INFORMATION

The laws of the following states were reviewed because their tax laws are similar to California's income tax laws. None of the states impose a tax that is similar to the additional 1% mental health tax.

Other State	PIT Rate	AMT Rate
Illinois	3% of net income (Flat tax)	None
Massachusetts	5.3% wages etc. 12% on capital gains (Flat tax)	None
Michigan	3.9% of taxable income	None
Minnesota	5.35 % to 7.85% of taxable income	6.4%
New York	4% to 7.7% of taxable income	Minimum Income Tax Rate 6% New York state residents 2.85% New York city residents

Alaska, Florida, Nevada, South Dakota, Texas, Washington, and *Wyoming* do not have a personal income tax.

Illinois allocates and apportions the income of nonresident individuals to determine the amount of income that is sourced to and, thus, is taxable by that state. Income of a part-year resident is sourced to Illinois for the part of the year that the individual was a resident, and apportioned inside and outside of the state for the part of the year the individual was a nonresident.

Under *Massachusetts* law, a nonresident is taxed only on income from sources within that state. Nonresidents are entitled to deductions only to the extent they relate to or are allowable against the income subject to tax in Massachusetts.

Michigan provides that nonresidents and part-year residents are taxed on all income earned in Michigan, or attributable to Michigan. Allocation and apportionment rules are provided for items such as business income, rents, royalties, interest, gains and losses.

New York taxpayers are subject to tax on income received from New York sources while a nonresident and on all income received while a New York State resident. Tax is figured on the federal AGI and includes all gains, losses and deductions, and is apportioned based on a percentage that represents New York source income.

FISCAL IMPACT

This bill would not significantly impact the department's costs. It would require changes to tax forms, publications, websites, and information systems, which could be accomplished during routine annual changes. A plan would need to be established to phase out PIT program areas throughout the department.

TECHNICAL CONSIDERATIONS

Amendment 1 is provided to correct a technical error.

ECONOMIC IMPACT

Tax Revenue Estimate

Based on data and assumptions discussed below, the revenue loss from this bill would be as follows:

Estimated Revenue Impact of SB 57 Effective On Or After January 1, 2007 Enactment Assumed After June 30, 2007 ($ in Billions)				
	2007-08	2008-09	2009-10	2010-11
Tax Rate Reductions	-$16	-$17	-$19	-$37
1% Mental Health Tax*	-$1	-$1	-$1	-$1
NR and Part-Year Residents	Minor	Minor	Minor	Minor

* This estimate does not affect the General Fund, but would eliminate transfers of funds to the Mental Health Services Fund.

This estimate does not consider the possible changes in employment, personal income, or gross state product that could result from this bill.

Revenue Discussion

The revenue estimates for the tax rate reductions are based on the department's latest personal income tax microsimulation model. The marginal tax rates were decreased over five years, from 2007 through 2011, and eliminated completely in tax year 2011. The alternative minimum tax (AMT) remained unchanged from 2007 through 2010. In tax year 2011, AMT was eliminated, resulting in the significant jump in revenue loss in fiscal year 2010-11.

The 1% mental health tax generated revenues of $1.3 billion in taxable year 2005. Due to the volatility of personal income that funds the 1% mental health tax, the approximate revenue loss, if repealed, would be an average of $1 billion.

The provision to change the taxing method of non-residents and part-year residents could have a minor impact relative to the other provisions in this bill. The minor impact could be a gain or a loss.

ARGUMENTS/POLICY CONCERNS

Because this bill would reduce regular PIT rates incrementally without making a corresponding reduction in AMT rates, the bill could increase the number of taxpayers who would owe AMT between 2007 and 2011.

Income taxes for sole proprietorships would be reduced and eventually eliminated by this bill. Yet, partnerships, limited liability companies, and C and S corporations would continue to pay taxes (minimum tax, fee, or income or franchise tax) under existing Corporation Tax Law, thus creating different treatment for businesses based on entity type.

LEGISLATIVE STAFF CONTACT

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FRANCHISE TAX BOARD'S
PROPOSED AMENDMENTS TO SB 57
As Introduced January 11, 2007

AMENDMENT 1

On page 6, line 23, after "arriving", insert:

"at"